IT 03-0015-GIL 04/28/2003 APPORTIONMENT – SALES FACTOR

General Information Letter: Director's fees for attending board meetings are business income and are included in the numerator of the sales factor if received for meetings in Illinois.

April 28, 2003

Dear:

This is in response to your letter to this office dated April 9, 2003. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information, the regulation governing the issuance of letter rulings, *2 Ill. Adm. Code Part 1200* regarding rulings and other information issued by the Department, can be accessed at the Department's website. That address is www.revenue.state.il.us/legalinformation/regs/part1200.

In your correspondence, you have specifically requested a GIL. In support thereof, you state in part as follows:

Facts

Our client ("Client" or "the Company") is a foreign (non-Illinois) corporation located outside Illinois, but having Illinois income and replacement tax nexus, that sells insurance contracts.

During December 2002, the Board of Directors of Client held a Director's meeting in Illinois at a hotel. The Board of Directors usually holds its meetings at the Company's headquarters located outside Illinois. All but one of Client's Directors are nonresidents of Illinois and performed no other activities in Illinois beyond attending one Directors' meeting. The Directors are paid fees of approximately $15,000 per year. The Directors generally attend four meetings per year and spend approximately five days preparing for the Board of Directors meetings and other Company business.

As noted, Client issues insurance contracts to Illinois policyholders. These policies represent approximately 3% of the Company's annual premiums received. As such, the Company itself has Illinois income and replacement tax nexus and timely files tax returns in Illinois.

RULING REQUESTED

We are submitting this request on behalf of the Directors, all but one of whom are Illinois nonresidents, who performed no activities in Illinois beyond attending one Directors' meeting at a hotel. It is requested, therefore, that the Department rule that the nonresident Directors would not be subject to the Illinois Income Tax. Further, in subsequent years, similar once-annual meetings held in the state would not subject the nonresident Directors to the Illinois Income Tax in such years if each nonresident

Director's Illinois activity were limited to attending such meetings.

ANALYSIS

The participation by Illinois nonresident members of the Company's Board in a Directors' meeting in Illinois would not subject such individuals to the Illinois Income Tax or other tax filing requirements.

Illinois will allocate income to the state, and thus subject nonresident individuals to income tax, if they are paid 'compensation in the state.' 35 Ill. Comp. Stat. 5/302(a). Compensation is considered paid in Illinois if: '(i) [t]he individual's service is performed entirely within [Illinois]; (ii) [t]he individual's service is performed both within and without [Illinois]; or (iii) [s]ome of the service is performed within [Illinois] and either the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within [Illinois], or the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in [Illinois].' 35 Ill. Comp. Stat. 5/304(a)(2)(B). According to the three-pronged statutory test and the applicable regulation, the nonresident board members do not appear to meet any of the definitions of Illinois activity such that their compensation would be considered 'paid in this state.' See also Ill. Admin. Code tit. 86, § 100.3120(a)(1).

The Directors in the instant matter are receiving fees for the performance of professional services, as opposed to salary compensation, which fees would represent self employment or business income subject to a different rule for purposes of potentially sourcing income to Illinois. Ill. Adm. Code tit. 86, § 100,3370(c)(3)(D)(iii) states that:

> Where services are performed partly within and partly without this State and the services performed in each state constitute a separate income producing activity, the gross receipts for the performance of services attributable to this State shall be measured by the ration which the time spent in performing such services attributable to this State shall be measured by the ratio which the time spent I performing such services I this State bears to the total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example, time expended in negotiating the contract, is excluded from the computations.

The regulation further provides an example where a public opinion survey corporation conducted a poll partly within and partly outside Illinois for the sum of $9,000. The project required 600 man-hours to obtain the basic data and prepared the survey report. Two hundred of the 600 man-hours were expended in Illinois. As a result, the receipts attributable to Illinois were calculated to be $3,000.

> Under U.S. and Illinois constitutional principles however, a nonresident individual must have the requisite nexus, or minimum connection, with Illinois to be subject to the Income Tax. Illinois has addressed the jurisdictional, or nexus, concept in the corporate income tax area. *See* Ill. Admin. Code tit. 86, §100.9720. The applicable nexus regulation provides for a de minimus activity exemption from nexus and it appears that the nonresident board members would qualify. In contrast, the example from Ill. Admin. Code tit. 86 § 100.3370, 200 man-hours were spent on Illinois activity. Such a level of in-state activity goes beyond the de minimus level, creating nexus for nonresidents and a filing obligation. On an analogous level, in the instant case, the nonresident Directors' Illinois activity would be considered de minimus and would not subject them to an Illinois Income Tax liability or filing requirements.

In a subsequent email to Paul Caselton dated 4/16/03 at 9:18am, your associate, Mr. Z, added the following:

> The full board meets eight times per year. There are four Committees that meet three times each per year. The Committees are: Executive, Finance, Compensation and Audit. The full Board and the Committee meetings generally take place outside Illinois. In December 2002, the full Board met in Illinois and in February 2003, the Audit Committee met in Illinois.
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> The Directors are paid a basic retainer fee of $15,000 per year. Each Board member of a Committee receives an additional annual retainer of $2,500 per Committee. Every Director is a member of at least one Committee. The Directors also receive $2,000 for each meeting they attend.
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> Every meeting occurs in one day and lasts only a few hours. For each meeting, Directors generally spend a day to prepare for the meeting and often a day after the meeting to complete follow up-tasks. Additionally, Board members are given Company financial statements to review on a regular basis.
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> Thus, for any one particular Illinois-based meeting, a nonresident Director receives $2,000 for work related to the meeting. Generally, this averages about three days of work, only one of which occurs in Illinois. The other two days most likely occur in the nonresident Directors' home states.

The issue of whether a taxpayer has nexus with Illinois is extremely fact-specific. Therefore, the Department does not issue rulings regarding whether a particular taxpayer has nexus with the State. However, general information regarding nexus with Illinois for income tax purposes may be provided.

The United States Constitution restricts a state's power to subject to income tax foreign corporations. The Due Process Clause requires that there exist some minimum connection between a state and the person, property, or transaction the state seeks to tax (*Quill Corp. v. N. Dakota*, 504 U.S. 298, 112 S. Ct. 1904 (1992)). Similarly, the Commerce Clause requires that a state's tax be applied only to activities with a substantial nexus to the taxing state. (*Id*.) In the case of foreign corporations, Illinois will assert nexus to tax unless the corporation falls under the narrow protection conferred by federal law (P.L. 86-272), regarding solicitation of sales of tangible personal property. (The narrow protection of P.L. 86-272 does not apply to cases involving the sale of personal services by individuals – as is

the case here. See below). As a general rule however, the Department interprets the concept of nexus as broadly as possible. Where any part of a foreign corporation's income is allocable to Illinois under Article 3 of the Illinois Income Tax Act (IITA), Illinois can demonstrate the connection or nexus necessary to subject a foreign corporation to tax.

Please be initially advised that, with respect to the Company's Director who is an Illinois resident, all of the income paid to him/her for Director services is allocable to and taxable in Illinois. Illinois Income Tax Act (IITA) §301(a).

Regarding the nonresident Directors, you have correctly cited the rules which pertain to allocating compensation income in the case of nonresident individuals. For purposes of this GIL, we accept your statement that none of the Directors is an employee of the Company as being true. Therefore the income the Directors receive from the company is not "compensation" and other allocation rules will apply, as you also noted. Your letter also states that "[t]he Directors in the instant matter are receiving fees for the performance of professional services…". Based upon that characterization, the income in question must be treated as business income and allocated under the appropriate apportionment rules.

As you correctly note, the rule for apportioning non-compensation business income received in exchange for the performance of personal services is set forth at 86 Ill. Adm. Code 100.3370(c)(3)(D)(iii). The formula and example explicated under that rule is that

> [w]here services are performed partly within and partly without this State and the services performed in each state constitute a separate income-producing activity, the gross receipts for the performance of services attributable to this State shall be measured by the ratio which the time spent in performing the services in this State bears to the total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal services not directly connected with the performance of the contract or other obligation, as for example, time expended in negotiating the contract, is excluded from the computations.
> Example: Corporation X, a road show, gave theatrical performances at various locations in State X and in this State during the tax period. All gross receipts from performances given in this State are attributed to this State.
> Example: A public opinion survey corporation conducted a poll by its employees in State X and in this State for the sum of $9,000. The project required 600 man hours to obtain the basic data and prepare the survey report. Two hundred of the 600 man hours were expended in this State. The receipts attributable to this State are $3,000, calculated as follows:
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> 200/600 x $9,000

As we see it, the $15,000 annual Director fee is partially apportionable to Illinois – the site from which some of it is earned due to substantive activity on the Company's behalf. In order to ascertain the correct percentage, the non-resident Directors would multiply that amount by a fraction, the numerator of which is 3 (the number of full Board of Directors meetings held in Illinois in 2002, plus one day of travel to and from the Illinois meeting) and the denominator of

which is 24 (the number of total meetings of the full Board of Directors in 2002, plus one day of travel to and from each meeting). That regulation excludes from the computation, for example, time spent negotiating a contract as compared to actual performance under the contract (see below). Additionally, we consider attendance and participation at each Committee meeting as a separate income-producing activity. Since the facts given reveal that each Director is paid $2,000 for attendance at each specific such meeting, it is the Department's position that the entire $2,000 would be attributable for any meeting held in Illinois such as the Audit Committee meeting held here in February, 2003. With respect to the $2,500 annual retainer paid to each Director for each Committee membership, that amount would be apportionable in part to Illinois for any year in which one or more Committee meeting was held here under the same formula used for the $15,000 annual Director fee.

As you have mentioned, the Department has promulgated a regulation Ill. Adm. Code 100.9720) interpreting the concept of nexus for IITA purposes. That regulation contains a provision exempting otherwise taxable transactions from IITA taxation if conducted in a manner deemed to be *de minimus*. That regulation (86 Ill. Adm. Code 100.9720(c)(2)(D)) provides as follows:

> De minimus activities are those that, when taken together, establish only a trivial additional connection with this State. An activity regularly conducted within this State on a regular or systematic basis or pursuant to a company policy (whether such policy is in writing or not) shall normally not be considered trivial. Whether an activity consists of trivial or non-trivial additional connection with this State is to be measured on **both a qualitative and quantitative basis**. If the activity either qualitatively or quantitatively creates a non-trivial connection with this State, then the activity exceeds the protection of P.L. 86-272. The amount of unprotected activities conducted within this State relative to the amount of protected activities conducted within this State is not determinative of the issue of whether the unprotected activities are de minimus. The determination of whether an unprotected activity creates a non-trivial connection with this State is made on the basis of the taxpayer's entire business activity, not merely its activities conducted within this State. An unprotected activity that would not be de minimus if it were the only business activity of the taxpayer conducted in this State will not be de minimus merely because the taxpayer also conducts a substantial amount of protected activities within this State, nor will an unprotected activity that would be de minimus if conducted in conjunction with a substantial amount of protected activities fail to be de minimus merely because no protected activities are conducted in this State. (emphasis added).

We are not persuaded by the argument you raise that the fact that only one meeting was held in Illinois in 2002 constitutes de minimus activity. According to the information provided, 3/24th (12.5%) of the Director meetings for 2002 were conducted in Illinois. We are not prepared to say such an amount is, by itself, de minimus. Furthermore, as noted above in the regulation, the de minimus exception takes into account both the qualitative as well as the quantitative nature of the activity which leads to the generation of the income sought to be taxed. In this case, the Directors in question met in Illinois in 2002 for the express purpose of conducting substantive Company business for which a day or more of lead-time preparation was required. This constitutes a qualitative activity which can be contrasted with, for example, a Director making a quick, substantive, telephone call to the Company while staying overnight in an Illinois hotel on non-Company affairs. The fact that every Director is a member of at least one of the four committees, and that an Audit Committee meeting also took place in Illinois in February, 2003, bolsters the conclusion that the decision to perform

substantive Company business in Illinois was more than a matter of happenstance. It is therefore our belief that the de minimus exception to nexus does not apply to these circumstances.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you wish to obtain a PLR which will bind the Department with respect to the application of the law to specific facts, please submit a request conforming to the requirements of *2 Ill. Adm. Code Part 1200*.

Sincerely yours,

Jackson E. Donley,
Senior Counsel-Income Tax